Preliminary Analysis of Alaska Oil Production Tax
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Introduction.

Legislation has been introduced that would revamp Alaska's oil production tax from a severance based tax based on the amount of oil produced, to a net profits based tax. The discussion is a preliminary analysis of the proposed legislation from a tax law perspective.

Most states impose a severance tax on minerals extracted, based on a fixed value per unit of minerals removed from the earth, or a percentage of the gross value. The principal advantage of a traditional severance tax is its simplicity and ease of administration. The oil company determines how much oil it produces, and pays the tax based on the per unit or percentage tax rate. The oil production tax proposed in the bill would calculate the net profit inherent in oil that is produced. The net profit is determined as the gross value of the oil produced during the month, less the production costs. Accordingly, the proposed bill would add a level of complexity not present in the existing tax. There are two principal disadvantages of this added complexity: (1) It allows oil companies more opportunities to plan their production activities in a way to minimize the net profits; and (2) It will require increased resources to the Department of Revenue to administer and enforce the tax.

Nature of the Proposed Tax.

The oil tax, as noted, is not a traditional severance tax, because it is not based on the value of the oil produced (although this is the starting point). Although Texas allows a deduction for natural gas marketing costs in calculating its gas severance tax, this deduction is designed to tax all gas on an equal footing even if it must be transported a further distance from the wellhead and is not considered a net profits tax. With this exception, we are unaware of any severance tax that is determined by deducting any cost (and the Texas deduction is not a production cost).

The proposed oil production tax is not really an income tax because the oil is taxed when it is pumped out of the ground, not necessarily when sold. However, it shares many characteristics of an income tax because the tax is determined on the gross value oil produced, less the production costs. Although the oil is a fungible commodity, easily sold on world markets, it nevertheless does not result in the recognition of gross income for federal income tax purposes until it is sold on the market, so it is not technically an income tax.

The tax also bears some resemblance to a tax on tangible personal property (i.e., the value of the oil produced), but a tangible personal property tax is imposed on the fair market value of an asset, with no deduction for costs.

This tax has a strong resemblance to a value added tax. Value added tax ("VAT") is the norm in the European Union. It imposes a tax by the value added at each stage of the production of a product. Since the proposed oil production tax is determined as the difference between the value of the oil produced and the value of the oil in the ground, the net difference is in effect the value added as a result of the production efforts of the oil companies, and therefore has the primary earmarks of a value added tax.

Apportionment of Tax.

The oil production tax bill does not apportion the tax on the proportion of the activities in Alaska to all production activities. Although a pure severance tax is not required to be apportioned, there is the potential that a value added tax might be challenged on constitutional grounds if it is not apportioned. As noted below, any such potential challenge can be preempted by Congress.

In order for a state tax that is imposed on a foreign corporation to be valid under the commerce clause of the U.S. Constitution, it must not discriminate against interstate commerce and must be fairly apportioned. It is possible that a corporation subject to the oil production tax might challenge the tax based on the argument that it is not fairly apportioned to the company's activities inside and outside Alaska. Although a pure severance tax based on the gross value of oil extracted should not have to be apportioned, because the tax base is determined on the number of barrels extracted, the determination of the net profits under the proposed tax takes into consideration activities that might occur outside of the state. Therefore, this might open the door to a challenge that the oil production tax violates the commerce clause requirement that the tax be fairly apportioned.

Michigan has had a value added tax - known as the Single Business Tax ("SBT") - since 1976. The SBT is apportioned based on a standard apportionment formula used by many states to calculate income tax liability based on the proportion of (sales, assets and payroll in the state over total sales, assets and payroll). An auto parts manufacturer based in Ohio challenged the SBT as violating the commerce clause, arguing that the tax was not fairly apportioned (Trinova Corporation v. Michigan 498 U.S. 358 (1991)). The Supreme Court upheld the SBT, holding that it was fairly apportioned. This case, however, raises the issue that a value added tax must be apportioned.

The Supreme Court has also ruled that a typical severance tax must satisfy the fair apportionment test in order to satisfy the requirements of the commerce clause. Commonwealth Edison Company v. Montana 453 U.S. 609 (1981). The court upheld the Montana coal severance tax, as being fairly apportioned, because the tax was a percentage of the value of the coal taken and therefore, was in proper proportion to the company's activities in the state.

Because the proposed oil production tax adds to the traditional severance tax calculation the determination of a company's cost to produce the oil, this could cause a disgruntled oil company, or possibly just a disgruntled citizen to challenge the tax based on the argument that the tax is not fairly apportioned. Since there is no other similar oil production tax that calculates net profits, it is difficult to predict how such a challenge would be greeted by the courts. This could create a level of uncertainty that could hinder the state's efforts to use the tax as a mechanism to help build the much needed gas pipeline.

One sure fix to this potential "fair apportionment" problem would be for the United States Congress to pass legislation authorizing a state to impose an oil production tax based on net profits like the proposed oil production tax. Since Congress has the power to regulate interstate commerce (as discussed more thoroughly below in the discussion on the tax credit), such federal legislation would cut short any potential challenge based on a commerce clause argument. Because of the important national energy security policy that would be advanced by the construction of a natural gas pipeline to bring domestic energy to American markets, Congress might be inclined to adopt such legislation.

Tax Credit-Constitutional Concern.

The 20% tax credit set out in Section 43.55.024 is a typical state tax incentive to encourage economic development.

Unfortunately, the legality of these tax incentives has been successfully challenged in Ohio, and the United States Supreme Court may soon decide the viability of these programs. The forthcoming Supreme Court decision, might invalidate the economic development tax incentives offered by states around the U.S. Such an adverse decision might invalidate the proposed Alaska tax credit.

The Ohio Case. The Supreme Court will review an appeals court case that declared illegal Ohio's corporate income tax credit for the purchase of new equipment - designed as an incentive for companies to expand investment in the state. The Ohio tax credit is very similar to the proposed Alaska tax credit.

The Ohio case, Cuno v DaimlerChrysler, involved incentives taken advantage of by DaimlerChrysler to build a plant in Toledo, Ohio. DaimlerChrysler was entitled to the Ohio investment tax credit for the purchase of equipment for the plant. In addition, as allowed by Ohio law, the City of Toledo granted a property tax abatement for the equipment purchased for the plant. The total incentives package was valued at $ 280 million. These substantial tax benefits were obviously a critical aspect of DaimlerChrysler's decision to build the plant in Toledo.

Individual taxpayers from Ohio and Michigan brought a legal action challenging the legality of these tax incentives in Cuno. The trial court dismissed the action. and the plaintiffs appealed to the Sixth Circuit Court of Appeals.

On Appeal, the Sixth Circuit ruled that the tax credit component of the Ohio tax incentive program for equipment purchases was illegal, as a violation of the commerce clause of the United States constitution. DaimlerChrysler appealed the case to the United States Supreme Court, which agreed to review this case.

The Commerce Clause. The Sixth Circuit found that the tax credit component of the Ohio program is illegal because it violates the commerce clause of the constitution. The commerce clause reserves to Congress all power to regulate interstate commerce. This is the provision of the constitution that creates the authority of the federal government to regulate all aspects of commerce. The commerce clause also prohibits states from putting up barriers to interstate commerce. One state can not create trade barriers to regulate the importation of goods from another state, either by regulation or tariffs. For example, a state can not impose a tax at a lower rate for products manufactured within its borders than for products made elsewhere. The plaintiffs in Cuno argued that the commerce clause prohibition against burdening business activity in another state by imposing a higher tax rate also prohibits Ohio from favoring investment within its borders. The Sixth Circuit agreed with this argument, concluding that the commerce clause prohibits a state from adopting tax incentives that favor investment in its state.

If the Supreme Court agrees with the Sixth Circuit Court that the Ohio tax credit violates the commerce clause, then the proposed Alaska tax credit would likely be invalid.

Possible Supreme Court Outcomes. The Supreme Court will hear oral arguments in Cuno on March 1, 2006. There are several possible outcomes when the Supreme Court decides this case.

The Court might very well decline to make any decision for now based on procedural grounds. The Court has asked the parties to file briefs based on the issue of "standing."Only someone who is directly effected by an act has the standing to file litigation in the courts. The plaintiffs in Cuno are individual taxpayers from Ohio and Michigan. The question that the Supreme Court wants them to address is whether an individual taxpayer has the standing to challenge the Ohio tax incentives. It is quite possible that the Supreme Court might rule that the harm suffered by these individual taxpayers as a result of these tax incentives is so indirect and tenuous that they do not have standing to bring this action. In such an event the entire case would be thrown out, and the Sixth Circuit decision would have no force or effect, at least for the time being. If this happens, then the plaintiffs in Cuno have indicated that they will take their case to the state courts, and litigate in that forum. If and when this happens, the entire process would start over, and presumably the case might again make it back to the Supreme Court. This process would likely take several years, leaving the final result up in the air.

The Supreme Court might decide to return this case back to the trial court for a determination of facts as to whether the Ohio tax incentives actually caused DaimlerChrysler to open the plant in Ohio, rather than in some other state. Because the trial court dismissed the case in its early stages, this evidence was not fully developed. By

sending this case back for a trial, the record would be more fully developed. It is possible that DaimlerChrysler was not swayed by the available tax benefits in making its decision to invest in Ohio. If so, this would likely end up back in the Supreme Court, a process that would also take several years.

The Supreme Court might decide to overrule the Sixth Circuit, and say that these tax incentives do not violate the commerce clause. This should return everything back to the status quo, and the proposed Alaska tax credit would likely be safe from the argument that it violates the commerce clause.

Finally, the Supreme Court might decide to affirm the Sixth Circuit, which would put an end to all similar tax incentive programs, including the proposed Alaska tax credit.

Intervention by Congress. Because the constitution gives to Congress the sole power to regulate interstate commerce, Congress has the authority to deal with the issue of state economic development tax subsidies. Accordingly, Congress has the power to fix the Sixth Circuit ruling. Even if the Supreme Court decides to uphold the Sixth Circuit, Congress has the power to statutorily overrule the Supreme Court. In fact, legislation has been introduced in both the House (H.R. 2471) and the Senate (S 1066) that would do just that - allow states to offer this type of tax subsidy. Accordingly, if these federal bills are adopted by Congress, and signed by the President, this would immunize the proposed Alaska tax credit from a potential commerce clause challenge. As such, the state should champion these bills in Congress if it intends to move forward with the tax credit for investment in Alaska.

Tax Credit- Transferability.

The bill would create Section 43.55.024(d) which would allow a taxpayer who has earned a tax credit to sell any unused tax credits, with the consent of the Department of Revenue. The problem with the sale of state tax credits is that they are frequently result in a sale at a deep discount (this is a major issue with state film production tax credits allowed by many states). This is not a desirable result because the state is paying 100 cents on the dollar for every dollar of tax credit, but the company that made the investment in the state is only getting a fraction of this amount. The difference - the "tax credit transfer profit" - goes to the companies that purchase the credit at a discount and the middlemen tax credit brokers who put the buyer and seller together.

Although the big oil companies will clearly be able to use all of the tax credits they earn, the exploration and development companies are less likely to be able to use up all of the credits that they earn. If the exploration companies sell their unused tax credits at a discount to the oil companies, then the oil companies (and any middlemen brokers) would recognize a significant benefit.

There are two potential fixes to this problem. The first would be to allow the tax credit as a credit against any other Alaska tax. This way, if an exploration company did not have

any oil production tax liability to use up the tax credit, it could at least use the tax credit to offset other Alaska tax obligations.

The second alternative would be for the state to "buy back" any unused credits at a modest discount. For example, say that a company could redeem unused tax credits at a 10% discount, so that if a company had $1 million in unused credits, it could sell these unused credits to the Department of Revenue for $900 thousand. In this way, it would be the state of Alaska that would gain the benefit of a 10% discount, not the oil companies who would purchase the credits at a discount. This would allow a market to develop for these tax credits at a reasonable discount. A company would not sell its tax credits to an oil company for 85 cents on the dollar if it can sell the unused credits back to the state of Alaska for 90 cents on the dollar.

Limitation on Carry Forward Tax Credit.

Section 43.55.04(c) allows a carry forward of the unused credit to a later month. This appears to allow a carry forward of any unused credit in a later month without any time limitation. The legislature might want to consider placing an outside time limitation.

Most corporate tax benefits that can be carried forward if they are unable to be used in the year earned have a limit to the number of years to which they can be carried forward. There are sound administrating reasons to place a limit on the number of years that carry forwards should be allowed. For example, tax examinations are much more difficult if the auditor has to look back to events generating the credit that occurred several years earlier. It also creates state budgeting complexities.

Outlay for Capital Expenditures - - Stock of Companies.

The direct expense deduction for outlays for capital expenses is quite broad, and it is not clear if it is intended that this deduction be allowed for the acquisition of the stock of another company that is involved with exploration development or production of oil or gas in Alaska. If this is the intention, then this should be expanded to prevent a direct cost expense if the Company merely purchases a related company from a common parent corporation.

For example, if the development subsidiary purchased the stock of a development subsidiary from the common parent corporation, the purchase price should not be allowed as a direct cost.

If it is not the intent of the legislature to allow a direct cost deduction for the purchase of the stock of a company, then this should be expressly stated.

Outlays for Capital Expenses - Related Party Transaction.

If an asset is purchased from a related company, and the company pays an amount that is greater than its fair market value, then the direct cost should be limited to the fair market value.

<u>Subtraction from Direct Costs - Ownership Interests.</u>

Section 43.55.160(e)(1) requires a company to subtract from direct costs the amount received from another company for the use of production facilities in which the taxpayer has an ownership interest. This should be broadened to include net payments received for the use of production facilities in which the taxpayer has a management agreement where the management fee is determined by the income received.

<u>Subtraction from Direct Costs - Credits and Reimbursements.</u>

Section 43.55.160(e)(2) requires a company to subtract from direct costs the amount of credits and reimbursements received from state and local governments for the company's upstream costs. This provision does not expressly state that this applies to tax credits, including the proposed oil and gas production tax credit. It is also not clear if this would apply to property tax exemptions. If it is the intent of the Legislature that tax credits and property tax exemptions should be subtracted from direct costs, then this should be expressly set out.

<u>Subtraction from Direct Costs - Recapture of Outlays for Capital Assets.</u>

Section 43.55.160(c) would allow a company to deduct its direct costs incurred in the exploration, development and production of oil and gas in calculating its net profit for purposes of the oil production tax. The term "direct cost" includes outlays for capital assets. There is a recapture provision in Section 43.55.160(e)(3)(A), which requires a company to subtract from direct costs the amount it receives from the sale or transfer of an asset that it previously deducted as a "direct cost". This rule is designed to prevent a company from churning assets merely to generate "direct cost deductions". For example, if a company purchases a piece of equipment for $1 million in June which would generate a direct cost deduction, and then sells it in July for $1 million, the amount received from the sale would be deducted in calculating its direct costs for July. In order to avoid manipulation of the intent and policy behind this rule, the concept should be expanded as follows:

(a) <u>Related Party Transactions.</u> If a company sells an asset to a related company for less than fair market value, then the amount it must subtract from its direct costs should be the fair market value of the asset.

(b) <u>Removal of Asset From Alaska.</u> If an asset that was purchased is subsequently removed from Alaska to be used by the Company elsewhere, this should be treated as a sale by the Company at its fair market value, so that it would be deducted from the Company's direct costs in the month that it was removed from Alaska. Otherwise a

company might attempt to enhance its deductions merely by purchasing assets for use in Alaska, and later moving it to another state or country for use there.

(c) Wash Sales. It is possible that a Company might attempt to increase its direct costs by selling an asset that it purchased prior to July 1, 2006, and purchasing an identical asset in order to generate a direct cost deduction. Since the asset that was sold was purchased prior to July 1, 2006, the amount received from the sale would not be deducted from direct costs, but the purchase of the identical replacement asset would be included in direct costs, thereby reducing tax liability without actually incurring any real direct cost. In order to prevent this type of manipulation, the recapture provision should be expanded to require the direct costs to be reduced by the amount received from the sale of an asset purchased prior to July 1, 2006 where a similar replacement asset is purchased.

Exemption for Small Producers.

Section 43.55.160(i) and (j) provides an exemption for smaller producers. In order to qualify for this exemption, a smaller producer must demonstrate that it is not owned by a single producer entity. This would prevent a large oil company from setting up numerous subsidiaries so that the oil produced by the subsidiaries would be exempt under the small producer exemption.

Large oil companies might try to circumvent this by banding together to form jointly owned enterprises. For example, if four oil companies each own 25% of several production companies, the bill should be clarified to make clear that such smaller production companies would not be eligible for this exemption, even though the ownership can not be attributed to a single large oil company.

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